

# Using Triggers to Beat the Market: The Charles Kirkpatrick “Relative” Approach

By Wayne A. Thorp, CFA

**D**espite the wild ride the stock market has taken over the last year or so, many still believe that stocks are the best investment vehicle available.

Among these investors is Charles Kirkpatrick, president of Kirkpatrick & Co., a technical research firm, and publisher of the Kirkpatrick Market Strategist. He holds the Certified Market Technician (CMT) designation and is an instructor at Fort Lewis College School of Business Administration.

In his book, “Beat the Market: Invest by Knowing What Stocks to Buy and What Stocks to Sell” (FT Press, 2008), Kirkpatrick outlines stock-picking and portfolio management strategies that he believes individual investors can follow to outperform the market while reducing the risk of capital loss.

While he is a technician who attempts to identify patterns to predict future movements in stocks, Kirkpatrick also believes that it is impossible to predict the market as a whole or the economy.



to overcome his own biases, Kirkpatrick spent a great deal of time testing specific investing methods. Based on these tests, he chose those methods that showed a history of performing well.

Kirkpatrick’s methods are all based on a strategy of “reaction,” which to Kirkpatrick means waiting for the market to indicate what it is going to do, and then reacting accordingly. Basically, this consists of buy and sell “triggers” that prompt an action. His buy and sell triggers are based on “relative” data elements—for example, price-to-sales, reported earnings growth, and price strength—in which his own analyses have shown patterns that have proven successful in the past.

In his book, Kirkpatrick presents three different investment models—a Growth Model, a Value Model and a Bargain Model—that all play on the same buy and sell trigger theme.

- The Growth Model requires strong relative earnings growth and strong relative price performance;
- The Value Model adds a price-to-sales ratio requirement to the Growth Model in order to reduce the risk of capital losses during a market downturn; in Kirkpatrick’s testing of the Value Model from 1998 to 2007, it outperformed both the Growth Model and the S&P 500 index.
- The Bargain Model uses the “best” triggers found in his testing of relative value, relative reported earnings growth, and relative price strength. Based on his testing, in 2007 the Bargain Model gained 77.3%, versus a gain of 25.3% for the Value Model and a 43.0% gain for the Growth Model; however, Kirkpatrick admits that several more years of testing are needed before labeling the Bargain Model a successful stock selection methodology.

## The Philosophy

Kirkpatrick notes that over the years, individual investors have been forced to take a more active role in the investment process, particularly with the growth of 401(k)-style retirement plans. In the process, many individuals have opted for mutual fund investments. But Kirkpatrick paints a less-than-flattering picture of mutual fund managers.

As an alternative, Kirkpatrick advocates that individuals invest in individual stocks, using a mechanical process to minimize the effects of emotions and “biases” that could have an adverse impact on their financial success. In order

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## Screening Using Relatives

Kirkpatrick feels that a big obstacle individuals face is deciding what to buy, and how to make that decision without having to predict anything.

In his book, he describes three principal methods for selecting stocks:

- Value,
- Growth, and
- Price strength.

These three selection methods provide the basis for the data elements of his analysis.

For his analysis, Kirkpatrick looks at “relative” data—data compared to other data. For example, when he is looking at value, he looks not only at the value of an individual company, but also at its value relative to the value of all other firms. He then attempts to maximize his profits by looking at only those companies with the best relative value.

### Value

When looking at a stock’s value, Kirkpatrick uses the price-to-sales ratio—the ratio of a stock’s price to the company’s cumulative sales for the last four quarters. He began using the price-to-sales ratio based on James O’Shaughnessy’s analysis in the book “What Works on Wall Street” and because sales data is less likely than earnings to be manipulated by company management.

Kirkpatrick analyzed the most effective way to use price-to-sales ratios. His analysis involved first calculating the weekly price-to-sales ratios for every stock over the period from 1998 to 2006. He then sorted the companies by price-to-sales ratio and ranked them into percentiles, where the companies with the highest price-to-sales ratios were in the highest percentiles. Once the companies were placed in percentiles based on their valuation, he calculated the relative price performance for each percentile for the proceeding three, six, and 12 months.

Kirkpatrick’s analysis found that there was an inverse relationship between the relative price-to-sales ratio percentile and their relative price performance three and six months

forward. In other words, as the price-to-sales percentile increased, the future performance decreased. For periods of 12 months, this relationship dissipated.

Kirkpatrick took these findings to suggest that investors should not focus on periods of longer than a year when using price-to-sales ratios.

### Growth

When looking at growth factors, Kirkpatrick prefers to look at growth in reported earnings, rather than forecasted earnings. While he admits that reported earnings are not error-free, Kirkpatrick questions the validity and accuracy of forecasted earnings.

In “Beat the Market,” Kirkpatrick describes how he calculates the reported earnings relative rankings for each stock: “I take the last four quarters of reported earnings for each company and calculate a ratio of this total to the four-quarter total one quarter earlier.”

The goal is to avoid seasonality, which is why he uses reported earnings over a full four quarters. Also, he uses operating earnings, which eliminates the impact of special charges or non-recurring items.

Once the reported earnings growth for all companies with positive earnings over both four-quarter periods is calculated, Kirkpatrick ranks the companies into percentiles; companies with the highest growth are in the highest percentile.

Kirkpatrick once again examined the three-, six-, and 12-month price performance of the earnings growth percentiles, and found, as expected, that there is a positive correlation between earnings growth and subsequent relative price performance. But he found the relationship was not as strong as it was for the relative price-to-sales ratio.

This finding indicated to him that reported earnings growth may not be as useful a selection criterion when testing over all market periods. Furthermore, he found that performance turns below-average for the percentile with the very highest reported earnings growth.

While Kirkpatrick was surprised by these results, they echo the sentiments

of investors who focus not only on strong growth but also on sustainable growth. Companies with high levels of growth cannot be expected to continue at those high levels over time.

### Price Strength

Kirkpatrick’s research indicates that relative price strength is the most reliable short-term stock selection technique.

There are a number of ways to calculate relative price strength. Some calculations compare the percentage change in stock price over a defined period to the percentage change in a stock index, such as the S&P 500, over the same period. However, these measures do not necessarily protect you in a down market, as a stock can be falling and still have “strong” relative strength if it is not falling as rapidly as the index.

Kirkpatrick is concerned about capital loss, so his relative strength calculation involves dividing the current weekly closing price by the 26-week moving average of closing prices. He adds up the week-ending closing prices for each of the last 26 weeks and divides this total by 26. For each subsequent week, the oldest price is dropped and the latest weekly close is added to calculate the moving average. He then ranks all the stocks so that those with the highest relative strength are in the highest percentile rank.

Kirkpatrick analyzed the price performance of these relative strength percentile rankings, and found that there is a very strong positive relationship between relative price strength and forward price performance. He writes: “Relative strength seems to breed more relative strength.” And he found, once again, that over time, this relationship gradually deteriorates.

Nonetheless, Kirkpatrick found that the relationship between the relative strength percentiles and price performance is still significantly stronger than relative valuations or reported earnings growth.

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### Sell Rules

Kirkpatrick’s three different models

use growth, value and price strength criteria to select stocks.

He also has a defined set of sell rules he uses to exit out of a position:

- **Growth Sell Rules:** The triggers include lower relative earnings growth, and lower relative price strength, along with a chart break of two previous lows (see his book for further explanation). Kirkpatrick uses the chart pattern rule to first identify stocks that are actually

rising in price. On the sell side, he uses chart patterns to automatically “sell” a stock if it declines by a predetermined amount. The chart pattern rule serves as his stop order. Kirkpatrick determines the previous important support level for the stocks in his portfolio. When a stock breaks two of these important support levels, Kirkpatrick removes it from the portfolio.

- **Value Sell Rules:** Include lower

relative price strength and lower reported earnings growth. However, stocks are NOT deleted for extraordinarily high relative price-to-sales ratios.

- **Bargain Sell Rules:** Include a more stringent relative strength ranking, along with more stringent relative price-to-sales ratio rankings.

Kirkpatrick’s philosophy, along with his buy and sell rules, are summarized in the accompanying table. ▲

## Kirkpatrick’s “Relative” Stock Selection Process in Brief

### Philosophy and Style

Charles Kirkpatrick believes a mechanical approach to investing will help investors avoid their own biases that ultimately cost them money. His buy and sell triggers are based on “relative” data elements—price-to-sales, reported earnings growth, and price strength. His analysis has led him to three investment models—Growth, Value, and Bargain.

### Universe of Stocks

For all three models, Kirkpatrick requires a minimum share price of \$10. For the Value Model, he requires a minimum market cap of \$500 million; he uses a \$1 billion minimum market cap for the Growth and Bargain Models.

### Criteria for Initial Consideration

#### Growth Model

- Relative price strength (as defined by current weekly closing price divided by the 26-week moving average of weekly closing prices) ranks in the 90th percentile or higher
- Relative reported earnings growth (as defined by the last four quarters of reported operating earnings divided by the four-quarter total of reported operating earnings one quarter prior) ranks in the 90th percentile or higher

#### Value Model

- Relative price strength ranks in the 90th percentile or higher
- Relative reported earnings growth ranks in the 90th percentile or higher
- Relative price-to-sales ratio ranks in the 30th percentile or lower

#### Bargain Model

- Relative price strength ranks in the 97th percentile or higher (may consider lowering to no more than 90th percentile to increase number of passing companies)
- Relative price-to-sales ratio ranks in the 17th to 42nd percentiles

### Secondary Criteria

For the Growth Model, Kirkpatrick uses point & figure charts to help in the buy and sell decision process. He only buys stocks for the Growth Model when they are in an upward trend, as indicated by two higher highs in a three-point reversal point & figure chart.

### When to Sell

#### Growth Model

- Relative price strength ranks in the 30th percentile or lower
- Relative reported earnings growth ranks in the 70th percentile or lower
- Chart break of two previous important lows

#### Value Model

- Relative price strength ranks in the 30th percentile or lower
- Relative reported earnings growth ranks in the 50th percentile or lower
- Stocks are not sold for extraordinarily high relative price-to-sales ratios

#### Bargain Model

- Relative price strength ranks in the 52nd percentile or lower
- Relative price-to-sales ratio ranks in the 7th percentile or lower, or in the 67th percentile or greater

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